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Docket No. R2000-1

DIRECT TESTIMONY

OF

EDWIN A. ROSENBERG

ON BEHALF OF

THE OFFICE OF THE CONSUMER ADVOCATE

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UNITED STATES OF AMERICA
Before The
POSTAL RATE COMMISSION
WASHINGTON, D.C. 20268-0001

Postal Rate and Fee Changes, 2000) Docket No. R2000-1

DIRECT TESTIMONY
OF
EDWIN A. ROSENBERG

I. STATEMENT OF QUALIFICATIONS

My name is Edwin A. Rosenberg. I am an economist employed by The National Regulatory Research Institute (henceforth, NRRI), which was established in 1976 by the National Association of Regulatory Utility Commissioners (NARUC). The NRRI is located at The Ohio State University in Columbus, Ohio, and its primary mission is to provide research and advice to members of NARUC, such as the Postal Rate Commission.

I have been at The NRRI since 1991. During that time I have authored or co-authored a number of reports and papers concerning regulatory issues. In addition, in 1994, I offered testimony before the Public Utilities Commission of Ohio in Case No. 93-487-TP-ALT. In that case, I, along with NRRI colleagues, evaluated a request by the Ohio Bell Telephone Company to shift to from cost-of-service, or rate-of-return regulation, to an alternative form of regulation – in this case, price-cap regulation. The Staff of the Commission sponsored my testimony in that case.

Prior to joining The NRRI, I taught economics and statistics at the University of North Carolina at Asheville and at North Carolina State University. Prior to that, I was an economist on the Staff of the North Carolina Utilities Commission and the Public Staff of that Commission. In that capacity I performed analyses and offered testimony on a variety of issues concerning the regulation of electric, natural gas, and telephone utilities in North Carolina.

I received a Bachelor of Arts degree in Economics from the University of North Carolina at Asheville (1971), a Master of Economics degree (1973) and a Doctor of Philosophy degree in economics (1985) from North Carolina State University.

II. PURPOSE AND SCOPE OF TESTIMONY

Robert Burns and I were asked by the Office of Consumer Advocate to consider the reasonableness of the United States Postal Service's request for a contingency provision in the amount of 2.5 percent of test-year revenues in this Docket. The authority for such a contingency provision is found in 39 U.S.C. §3621, which states that:

> Postal rates and fees shall provide sufficient revenues so that the total estimated income and appropriations to the Postal Service will equal as nearly as practicable total estimated costs of the Postal Service. For purposes of this section, "total estimated costs" shall include (without limitation) operating expenses, depreciation on capital facilities and equipment, debt service (including interest, amortization of debt discount and expense, and provision for sinking funds or other retirements of obligations to the extent that such provision exceeds applicable depreciation charges), and *a reasonable provision for contingencies.*[1]

[1] Emphasis added.

Thus, the question is not whether there should be a provision for contingencies but, rather, whether the amount requested is reasonable.

III. RECOMMENDATION

I believe that an increase in the contingency provision from the existing level of one percent of total estimated costs to 2.5 percent of total estimated costs is neither necessary for the continued successful operation of the Postal Service nor in the public interest. Such an increase would tend to raise rates charged for postal services above reasonable levels given the costs incurred by the Postal Service. At this time, the existing contingency provision of one percent of total estimated expenses should be continued.

I have formed my opinion as a result of the application of a combination of sound public policy and regulatory principles and evaluation of USPS Witness Tayman's testimony and exhibits.[2]

The rates of the Postal Service are set using basic principles of cost-of-service regulation. This principle is found in 39 U.S.C. §3621, which, as noted earlier, states that

> Postal rates and fees shall provide sufficient revenues so that the total estimated income and appropriations to the Postal Service will equal as nearly as practicable total estimated costs . . . and a reasonable provision for contingencies.

[2] USPS-T-9.

Thus, rates should be just sufficient to cover estimated expenses and allow for some unforeseen or uncontrollable circumstances, but they should not be more than is reasonably sufficient to do so.

The form of rate regulation applied to the Postal Service is a variant of a form of regulation that has been applied in various public utility sectors in the United States for many years. Though widely applied, cost-of-service regulation was subject to many criticisms. These included its "cost plus" nature and lack of strong incentives for regulated firms to minimize costs, the interaction of historical test years and regulatory lag (causing rates to tend to lag costs during periods of rising costs), and prohibitions against retroactive ratemaking (barring regulated firms from recovering economic losses incurred when revenues did not cover total costs). Several of these shortcomings in cost-of-service regulation are avoided in the specific application form to the Postal Service.

First, in determining the level of test-year estimated expenses, revenues, and revenue deficiency, the Postal Service is not required to use a strict historical test year. Indeed, in estimating test-year revenues and expenses, the Postal Service is allowed to begin with an historical base period and make many *pro forma* or "roll-forward" adjustments to account for factors that are known or expected to occur outside the historical base year. Thus, the estimated revenues and expenses for the test year, especially on an "after rates" basis, represent the best available estimates or projections of Postal Service management.

Second, in addition to allowing for *pro forma* adjustments to arrive at test-year revenue and expense accounts, a reasonable provision for contingencies is added to

the forecast revenue requirement. This provision provides some safety margin should the estimated revenues and expenses miss the mark due to unforeseen, unexpected, and uncontrollable factors that adversely affect revenues and/or expenses.

Third, if the estimated revenues and expenses are way off target, and the contingency provision should, therefore, turn out to be too small, the resulting operating deficit can be recovered in the future on an amortized basis through the use of the recovery of prior years' loss provision. Of course, reliance on recovery of prior years' losses should be minimized, since this creates an inter-temporal transfer to the extent that future customers are asked to pay costs that rightly belong to today's customers. Nevertheless, the existence of this provision provides an additional level of protection for the Postal Service.

Thus, the Postal Service has three different levels of protection that provide it with a reasonable opportunity to meet its goals of breaking even financially while providing good service to consumers at reasonable rates. Indeed, Mr. Tayman's testimony and exhibits point this out. The Postal Service has posted positive net incomes, or is projected to do so, in each year from 1995 through 2000.[3]

Although regulatory lag is often considered to be a deficiency, the existence of regulatory lag can act to provide incentives for managers to minimize costs. The process of resetting postal rates is time consuming, and there is a lag between the projection or realization of the need for an increase in the general level of postal rates and their implementation. During this period, managers are likely to find themselves in

[3] USPS-T-9, p. 3-4.

the position of having to make decisions to hold down costs so that the Postal Service is able to come as close as possible to its break even target. This may be considered to be a good thing, since managers *should* be in a position of having to seek ways of controlling costs. Indeed, It is presumed that the Postal Service will exercise "honest, efficient, and economical management."[4]

The allowance for a contingency provision in the revenue requirement is, in my opinion, a form of insurance against unforeseen, unexpected, and uncontrollable adverse fluctuations in revenues and/or expenses. The Postal Service is allowed to adjust historical data to reflect known or projected changes in revenues and expenses; nevertheless, there will almost certainly be some fluctuations that are not accounted for. So the contingency provision serves as a cushion against occurrences that could not reasonably be forecasted or foreseen. In addition, because of its cushioning effect, it serves, implicitly, to lengthen the time between postal rate increases. A larger contingency provision provides more of a cushion; a smaller contingency provision provides less of a cushion. The essential question is: What is the optimum size of the contingency?

A disciplined analysis of the optimum size of a contingency provision would consider the following factors:

1) The magnitude and types of uncertainties that necessitate the existence of a contingency provision. Of particular concern in this regard is the state of the economy.

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[4] 39 U.S.C. § 3621.

2) The historical experience of the Postal Service with respect to its contingency provision. How has the Postal Service fared under various contingency provisions?

3) The short-run and long-run effects of the contingency provision turning out to be either too large or too small.

a) On the Postal Service and its managers

b) On the customers of the Postal Service

After considering these factors, the contingency provision may be set at a level that considers existing circumstances and balances the various interests involved.

In my opinion, the requested increase in the contingency provision from one percent to 2.5 percent of total expenses is not necessary at this time, and a contingency provision of one percent of total estimated expenses should be allowed. I have come to this opinion based on consideration of a number of factors.

IV. FACTORS CONSIDERED IN RECOMMENDATION

A. Economic Conditions Are Relatively Stable

One major purpose of the contingency provision is to ensure against forecast errors and unforeseen and uncontrollable events that have adverse consequences on revenues and/or expenses. Other things being equal, relatively favorable and stable economic conditions at present and forecasts of reasonable stability over the near-term future can be expected to strengthen the ability of the Postal Service to forecast revenues and expenses on a going forward basis, so the Postal Service's estimates would be expected to be more reliable now than in more uncertain times. More

accurate forecasts or estimates would tend to allow for a relatively smaller provision for contingencies.

At the present time, the United States is operating in a climate of relatively low inflation, and the Federal Reserve Board, under Chairman Alan Greenspan, is committed to hold inflation at moderate levels. Indeed, recent increases in the target federal funds rate are pre-emptive strikes against nascent inflationary pressures. Tables 1, 2, and 3 present excerpts from recent macroeconomic forecasts by the Congressional Budget Office, Deutsche Banc Alex. Brown, and Standard and Poor's DRI for 2000 and 2001. The historical path of consumer price inflation is shown in Figure 1 and there is reasonable consensus that inflation is likely to continue to be moderate through 2001. I have included DRI's April 2000 forecast of CPI inflation rates for 2000 and 2001 taken from Table 3.

Figure 1
CPI Inflation 1970 - 2001

Historical Data from Table 4
Estimates for 2000 and 2001 from Table 3

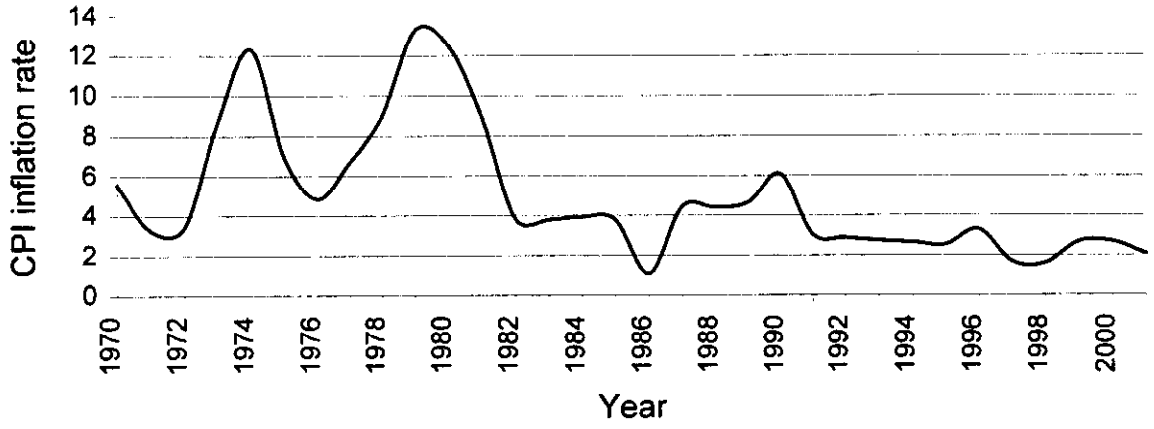

Table 1
Congressional Budget Office
Forecast for 2000 and 2001

Variable	Estimated	Forecasted	
	1999	2000	2001
Fourth Quarter to Fourth Quarter (Percentage change)			
Nominal GDP	5.3	4.6	4.7
Real GDP	3.9	2.9	3.0
GDP Price Index	1.4	1.7	1.6
Consumer Price Index	2.6	2.3	2.5
Consumer Price Index Excluding Food and Energy	2.1	2.3	2.5
Calendar Year Average (Percent)			
Real GDP	3.9	3.3	3.1
Unemployment Rate	4.2	4.1	4.2
Three-Month Treasury Bill Rate	4.6	5.4	5.6
Ten-Year Treasury Note Rate	5.6	6.3	6.4

Source: Congressional Budget Office, *The Budget and Economic Outlook: Fiscal Years 2001-2010*, released electronically on January 26, 2000.[5]

[5] Accessed at http://www.cbo.gov/showdoc.cfm?index=1824&sequence=0&from=7, May 11, 2000.

Table 2
Deutsche Banc Alex. Brown
Economic Forecast

Variable	2000	2001
Annual Percent Change		
CPI	2.7	2.0
Implicit Price Index	1.8	1.6
Real GDP	3.8	4.0
Unit Labor Costs (nonfarm)	0.8	1.8
Hourly Comp. (nonfarm)	4.4	4.7
Productivity (nonfarm)	3.5	2.8
Annual Average		
Unemployment Rate	3.9	3.7
3-Month Treasury Bills	6.0	6.2
10-Year Governments	6.2	6.1
Prime Rate	9.2	9.5

Source: Deutsche Banc Alex. Brown[6]

Table 3
DRI's Forecast for the U.S. Economy

Variable	1999	2000	2001
Annual Percent Rate of Change			
Real GDP	4.1	4.5	3.0
GDP Price Index	1.4	1.7	1.6
CPI (all urban consumers)	2.2	2.7	2.1
CPI excluding food And energy	2.1	2.3	2.3
Employment Cost Index	3.2	4.3	4.0
Output per Hour	3.0	3.0	1.8
Annual Average			
Unemployment Rate	4.2	3.9	4.0
Prime Rate	8.0	9.2	9.7
Thirty-Year Treasury Bond Yield	5.9	6.1	6.0
Treasury Bill Rate	4.6	5.9	6.1

Source: Standard & Poor's DRI, CONTROL0400 Forecast, April 2000

6 Dated May 5, 2000, http://www.yardeni.com, May 11, 2000.

The United States is currently enjoying the longest economic expansion in over half a century. We continue to have robust economic growth combined with low and relatively stable inflation. These conditions should allow the Postal Service to meet its responsibilities with a minimum provision for contingencies.

B. The Recent Financial Success of the Postal Service

The recent experience of the Postal Service is that it has been able to achieve a positive net income over the two most recent rate cycles with a contingency provision less than the 2.5 percent requested. Nothing in the recent operating history of the Postal Service suggests that the 2.5 percent request is necessary.

Unlike some situations that the Postal Service has experienced historically, there is no chronic or growing deficit resulting from an over forecast of revenues and/or under forecast of expenses. As shown in Mr. Tayman's Exhibit 9L,[7] the Postal Service has achieved a positive net income in every year since 1995 and is projected to do so during FY 2000.

In fact, during the 1995 through 2000 period, the Postal Service generated a cumulative net income of $5.58 billion.[8] The contingency provision was set at two percent in Docket No. R94-1 and at one percent in Docket No. R97-1. In each year since implementation of the rates approved in R94-1, the Postal Service has operated quite successfully with a contingency provision less than the 2.5 percent it has requested in this Docket.

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[7] USPS Exhibit 9L.

[8] Calculated from USPS Exhibit 9L.

C. The Postal Service's Ability to Forecast is Improving

During the period immediately subsequent to the Postal Reorganization Act of 1970, the Postal Service entered a new environment. It has now had nearly thirty years of experience operating in a more business-like manner. Thirty years of experience in exercising honest, efficient, and economical management, by itself, justify a smaller contingency provision than was necessary as the Postal Service sailed into uncharted waters after its reorganization.

In addition, economic conditions – especially inflation rates – were much more volatile and uncertain in the 1970s and 1980s than they are today. Inflation was, on average, considerably higher then than it has been recently or than it is expected to be over the near-term future. Historical inflation figures based on December-to-December changes in the CPI for all urban consumers are shown in Table 4.

The rate of inflation is a major area of uncertainty that leads to the necessity of a contingency provision. Other things being equal, higher rates of inflation may justify relatively larger contingency provisions.

In addition to operating in a relatively stable economic climate, in Fiscal Year 1999 the Postal Service created a sixteen-person forecasting organization within its Finance function. The goal of that group is to create more accurate and reliable forecasts.[9] More accurate and reliable forecasts would tend to reduce uncertainty and allow for a smaller contingency provision.

[9] Tr. 2/146.

Table 4
Consumer Price Index for All Urban Consumers:
All Items, 1982-84=100, Not Seasonally Adjusted

Year	December Value	Annual % Change	Year	December Value	Annual % Change
1969	37.7	n.a.	1985	109.3	3.80
1970	39.8	5.57	1986	110.5	1.10
1971	41.1	3.27	1987	115.4	4.43
1972	42.5	3.41	1988	120.5	4.42
1973	46.2	8.71	1989	126.1	4.65
1974	51.9	12.34	1990	133.8	6.11
1975	55.5	6.94	1991	137.9	3.06
1976	58.2	4.86	1992	141.9	2.90
1977	62.1	6.70	1993	145.8	2.75
1978	67.7	9.02	1994	149.7	2.67
1979	76.7	13.29	1995	153.5	2.54
1980	86.3	12.52	1996	158.6	3.32
1981	94.0	8.92	1997	161.3	1.70
1982	97.6	3.83	1998	163.9	1.61
1983	101.3	3.79	1999	168.3	2.68
1984	105.3	3.95	2000	n.a.	n.a.

Source: U.S. Department of Labor, Bureau of Labor Statistics[10]

Using the data shown in Table 4, I have calculated the simple averages of the annual rates of change in the CPI for various periods. These simple or arithmetic averages are shown in Table 5.

[10] Accessed at http://www.stls.frb.org/fred/data/cpi/cpiaucns May 16, 2000.

Table 5
Arithmetic Averages of Annual CPI
Inflation Rates and Contingency Provision
(Inflation Data from Table 4)

Period	Arithmetic Average of Annual CPI Inflation Rates	Contingency Provision Recommended by the PRC	Case and Effective Dates
1970 - 1975	6.93%	n.a.	n.a.
1976 - 1980	9.28%	4%	R76-1, May 1978 to March 1981
1981 - 1985	4.86%	4%	R76-1, May 1978 to March 1981 R77-1, March 1981 to October 1981
		2.5%[11]	R80-1, November 1981 to February 1985
		3.5%	R84-1, February 1985 to April 1988
1986 - 1990	4.14%	3.5%	R84-1, February 1985 to April 1988
		3.5%	R84-1, April 1988 to February 1991
1991 - 1995	2.79%	3.5%	R90-1, February 1991 to December 1994
		2%	R94-1, January 1995 to January 1999
1996 - 1999	2.33%	2%	R94-1, January 1995 to January 1999
		1%	R97-1, January 1999 to present

Table 5 shows that the average rate of CPI inflation has generally been declining since 1980. Table 5 also includes information on the time path of the contingency provision recommended by the Postal Rate Commission during the various time

[11] The PRC recommended 2.5%, but the recommendation was appealed, and the effective contingency provision was 3%.

periods. As can readily be seen here and in Figure 1, above, the time path of inflation has both trended lower and become less erratic in recent years. Both lower inflation and less erratic inflation are factors that support a smaller contingency provision. This is confirmed in the downward trend of the contingency provision over time. To increase the contingency provision from the current one percent to 2.5 percent would certainly deviate from the past trend illustrated in Table 5.

D. The Existence of Other Safety Net Provisions

Remember that the contingency provision is one of several built-in safety nets to ensure the viability of the Postal Service, the others being the use of *pro forma* estimates of revenues and expenses, the provision for recovery of prior years' losses, management's ability to control expenses, and the Postal Service's ability to borrow. Finally, I would note that the Postal Service is able to request new rates if it experiences revenue shortfalls and/or expense increases that put it in jeopardy.

Although the recovery of prior years' losses provision and borrowing authority should not be relied upon as substitutes for the contingency provision, the existence of these additional safety nets may be taken into account when making a recommendation as to the appropriate size of the contingency provision. If neither the recovery of prior years' losses provision nor borrowing were available, the appropriate contingency provision would be larger.

E. The Requested Increase in the Contingency Provision Is a Major Component in the Revenue Deficiency and Should Be Justified

The increase in revenues necessary to move from a contingency provision of one percent to a contingency provision of 2.5 percent is more than 27 percent of the

revenue requirement deficiency. Mr. Tayman states that "[t]he Test Year deficiency . . . will be approximately $3.7 billion . . . ."[12] On an "after rates" basis, the increase in the contingency reserve is, by itself, approximately $1,007,859,510.[13] In fact, if calculated on an "after rates" basis, with an adjustment for cost savings, the increase is over 36 percent of the total revenue increase.[14] An increase of the magnitude sought in this Docket should, I believe, require well reasoned justification; saying it is needed doesn't necessarily make it so.

F. Many Potential Sources of Expense and Revenue Variation are Accounted for in the Estimated Revenues and Expenses

In his discussion of the provision for contingencies, Mr. Tayman notes that

> Volume growth is below historical norms and projections of Fiscal Year 2000 require workyears be held at the Fiscal Year 1999 level while mail volume and the delivery network continue to grow.[15]

Mr. Tayman also states that

> Health benefit cost increases have now returned to near double digit rates. Also, the labor contracts which have become effective since the last rate filing are significantly more costly than previous contracts.[16]

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12 USPS-T-9, p. 10.

13 USPS-T-9, p. 22, Table 15.

14 USPS-T-9, p. 52, Table 58.

15 USPS-T-9, pp. 43-44.

16 USPS-T-9, p. 44.

However, he admitted that

> estimated volume and delivery network changes and changes in the level of costs in employee benefits have been accounted for in the estimation of test year revenues and expenses.[17]

Therefore, these factors cannot be adduced to justify the contingency provision, and they certainly cannot be used to justify *increasing* the contingency provision by more than $1 billion. Moreover, Mr. Tayman stated that

> The Postal Service's financial performance is under much greater pressure and is subject to substantially greater risks than it was at the time of the last two omnibus rate cases.[18]

However, he has also admitted that this statement is "subjective and intuitive" and that he had performed no studies in this area.[19] My colleague, Robert Burns, discusses in greater detail the reasons for which Mr. Tayman's testimony is inadequate to support an increase in the contingency provision.

V. THE REQUEST FOR A CONTINGENCY PROVISION OF 2.5 PERCENT IS NOT SUPPORTED BY THE POSTAL SERVICE'S VARIANCE ANALYSIS

A. The Requested 2.5 Percent Lies Outside the Range of the Variance Results

The variance analysis presented in Mr. Tayman's Exhibits[20] also fails to support the necessity of a 2.5 percent contingency provision. The requested contingency provision of 2.5 percent of total estimated costs lies *outside the range* of the results of

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17 Tr. 2/280.

18 USPS-T-9, p. 45.

19 Tr. 2/304.

20 USPS Exhibit 9J, pp. 5-8.

the variance analysis, which is from a positive 2.2% to a negative 2.3%. The mid-point of the range of the four results is nearly zero (negative 0.05%). Moreover, even though, as shown in Table 6, three of the scenarios presented assume lower than expected revenues, the *total* of the four scenarios is negative, but it is less than one percent of estimated test year costs. Furthermore, the *average* across the four scenarios is negative, but it is less than one-quarter of one percent of estimated test year costs.

Mr. Tayman does not favor using the variance analysis to determine the size of the contingency provision. He states

> No matter what results an historical variance analysis produces, it is not appropriate to use historical data to determine the size of the contingency in lieu of management's judgment about the future.[21]

The Postal Service prefers, instead, to rely upon largely judgmental and subjective guesstimates in determining the requested contingency provision. This appears to be an attempt for the Postal Service to have their cake and eat it too: recognizing that their *ex ante* forecasts may turn out to be wrong *ex post* – leading to the necessity for the provision for contingencies – but asserting their ability to accurately gauge the amount by which their forecasts are likely to be wrong.

[21] USPS-T-9, p. 45.

Table 6
Results of Variance Analysis

Scenario	Net Effect $ 000's	Net Effect %
Revenues .962% higher than expected; Expenses 1.177% lower than expected	$1,455,557	2.2%
Revenues .9165% lower than expected; Expenses 1.119% lower than expected	$118,279	0.2%
Revenues .1367% lower than expected; Expenses .9429% higher than expected	- $728,039	- 1.1%
Revenues 1.23% lower than expected; Expenses .9878% higher than expected	- $1,513,889	- 2.3%
Total	- $668,092	
Total as a % of Test Year Estimated Cost	- 0.994%	
Average	- $167,023	
Average as a % of Test Year Estimated Cost	- 0.2486%	

Source: USPS Exhibit 9J, pp. 5-8

If we consider the Postal Service's ability to forecast revenues and expenses on an "after-rates" basis, using the figures contained in USPS Exhibit 9J, page 3 of 8, we find that the total estimated "after-rates" revenues for the test years in the four previous rate cases (Docket Nos. R87-1, R90-1, R94-1, and R97-1) were $200,925.4 billion,[22] and actual after-rates revenues for the four years were $200,650.8 billion. Thus, the Postal Service's revenue forecast for the four years was a total of $274.6 million, or 0.14 percent, high with two overestimates and two underestimates. On the expense side, total expenses were estimated to be $195,954.1 billion and actual total expenses

[22] Using the "before-rates" estimated revenue for the test year in Docket No. R97-1, because the Docket No. R97-1 rates were not, in fact, implemented during the test year.

were $198,805.7 billion. Thus, the Postal Service's expense forecast for the four years was a total of $2.8156 billion, or 1.46 percent, low, with one overestimate and three underestimates. Over the four years, this amounts to an underestimate of net income totaling $3.1262 billion, or 1.57 percent, of total actual costs (or 1.6 percent of total estimated costs). However, in only one of those years (FY1992) was there an actual net loss. Thus the actual experience of the Postal Service after the last four rate cases does not support increasing the contingency provision from one percent of estimated total costs to 2.5 percent of estimated total costs.

B. Other Analytical Methods are Available

The Commission finds variance analysis to be a useful tool, but not the only means to evaluate the reasonableness of a requested contingency provision. Other analytical methods are available that might be useful. For example, in the electric utility industry, a similar situation often arises. Electric utilities require some excess generating capacity (a reserve margin), over and above their projected peak load, to allow for unexpected weather-induced periods of high demand and/or for unplanned outages of generation plants.

Electric utilities attempt to keep a reasonable amount of reserve capacity available so that consumers are not faced with power brownouts or blackouts during extreme weather – and consumers pay for the maintenance of this reserve capacity. Greater reserve capacity decreases the probability that extreme weather or an unplanned plant outage will result in the utility's inability to meet the demand placed on

its system (loss of load), but greater reserve capacity is costly, so the costs and benefits of a greater or lesser amount of reserve capacity must be considered.

One commonly used way of determining whether a utility has sufficient, but not excessive, reserve capacity is to use loss of load probability analyses (LOLP). These probabilistic analyses simulate weather variation and allow for random unplanned plant outages. Based on hundreds or thousands of Monte Carlo simulations of various demand and plant availability conditions, the LOLP can be calculated for different plant configurations. If the LOLP for a given mix of plants is at or just below some predetermined value in terms of percent or days per year, the reserve capacity is considered adequate, but not excessive. Another criterion sometimes used is that there should be sufficient reserve capacity to meet projected peak loads when one, two, or even three of the largest plants are forced out of service unexpectedly.

In addition, LOLP analyses are also considered in light of the possibility that a utility facing internal supply constraints may be able to purchase power from utilities or other power generators that have excess capacity at the time, and that the utility may be able to control portions of its load by curtailing service to customers receiving power under interruptible contracts or by engaging in other demand-side management practices. Again, although the goal is to ensure sufficient capacity to meet customers' needs, given the vagaries of weather and unplanned outages, consideration is given to the relative costs and benefits of more versus fewer reserves.

Telephone companies and natural gas companies also face analogous questions when making decisions related to network design or the amount of stored reserves to have on hand, respectively. Similarly, there are analytical models that have

been developed to aid in the decision making process in these industries.

Although the situation facing the Postal Service is somewhat different, it would be useful for the Postal Service to develop some form of more analytical approach to determining the likely range of outcomes and assigning some likelihood or probability weights to them.

VI. LARGER CONTINGENCY PROVISIONS ARE NOT PREFERABLE

The contingency provision must provide a cushion, but the cushion should not be so thick as to be overly comfortable. Given the Postal Service's mandate to achieve break-even results, it is presumed that managers will exercise diligent and efficient practices in doing so. Nevertheless, if the allowed contingency provision is too large, the cushion may result in a tendency toward slackness. This is a form of what economists call moral hazard. This does not imply immoral behavior; rather, it means that the structure of incentives and rewards may not lead to cost minimizing behavior. The contingency provision is a form of insurance against unforeseen and uncontrollable events.

Let me provide two examples. In the electric utility industry, a major source of uncertainty or risk is the price of fossil fuel (coal, oil, natural gas). Regulators often allow utilities to pass through to customers the changes in their cost of fuel in the form of fuel cost adjustments. If, however, the utility is allowed to pass along 100 percent of its fuel costs, it might not have sufficient incentive to hold costs down, so some regulators have introduced provisions that require the utility and its shareholders to bear some of the risk. Likewise, the use of deductibles in insurance policies tends to

give policyholders an incentive to minimize losses and claims. Such incentive would not be present if policyholders were made whole for losses regardless of whether they had taken care to prevent them.

If the contingency provision is too generous, managers can still meet their break-even goal in the face of adverse circumstances without having to make tough decisions. Mr. Tayman stated that the Board of Governors' policy is for "the Postal Service [to] generate a net income equivalent to the recovery of prior year loss provision amount included in the most recent rate filing and rates that are in place."[23] If that goal is not being met, the Postal Service is directed to look for ways to generate additional revenues or reduce expenses. Once those items are exhausted, the Postal Service is to resort to filing for increased rates.[24] A contingency provision that is overly generous can relieve Postal Service management of the pressure to manage economically and efficiently.

VII. OTHER REASONS NOT TO INCREASE THE CONTINGENCY PROVISION

A. The Extra $1 Billion Needed to Increase the Contingency Provision Is Not Costless

The extra $1 billion required to fund the requested increase in the contingency provision from one percent to 2.5 percent of total estimated costs will not come out of thin air. It will come out of the pockets of the customers of the Postal Service in the form of higher rates and fees they must pay. The additional dollars paid to the Postal

[23] Tr. 2/557.

[24] *Id.* at 557-8.

Service to increase the contingency provision are dollars that customers cannot allocate to other things such as consumption, investment, and saving. Customers will suffer an opportunity loss as a result, and there has been no analysis produced that takes these costs into account.

The opportunity cost that customers bear as a result of funding a larger contingency provision is not less than the rate of interest on U.S. Treasury securities, and it is most likely considerably higher than that, since businesses routinely borrow at rates well above Treasury rates; individuals carry credit-card balances, automobile loans, or other consumer debt at higher rates; and businesses and individuals have investment opportunities such as equity securities that have expected returns considerably higher than Treasury rates.

It maybe argued that a larger contingency could give customers an indirect benefit since it could tend to lengthen the rate cycle, so that postal rates and fees may stay stable a bit longer. However, even if there were such an indirect benefit, it is not the purpose of the contingency provision. Moreover, if the Postal Service decides to file more frequent rate cases (as is discussed in the testimony of OCA witness Callow), the contingency provision could be lower in light of the shorter period for which unforeseen and uncontrollable events are being provided for.

B. Shortening the Rate Cycle Can Allow for a Smaller Contingency Provision

Postal Service rates are reset on a periodic basis as necessary for its continued operations. A major reason for the existence of the contingency provision is to provide some protection against unforeseen, unexpected, and uncontrollable factors that

adversely affect revenues and/or expenses. The Postal Service forecasts or estimates the effects of all reasonably foreseeable events on the horizon. Nevertheless, there will be some unforeseen events – some positive and some negative – that change revenues and/or expenses from their estimated values. The farther into the future we attempt to see, the greater the likelihood that forecasts or estimates will err. Thus, by shifting from a rate cycle based on the presumption that rates will remain in effect for three to four years – as was the case from 1981 through 1998 – the size of the contingency provision can be lowered, since the near-term future is likely to be more predictable than the longer term.

This is similar to the notion that the more often a business plans to restock its inventory, the smaller its inventories can be and the lower its carrying costs. The contingency provision may be likened to business inventories in that they both provide a buffer against uncertain fluctuations.

The Docket Nos. R84-1 and R87-1 rates were each in effect for slightly less than three years, and the R90-1 and R94-1 rates were in effect for about four years. Assuming that the Docket No. R2000-1 rates are effective January 1, 2001, the Docket No. R97-1 rates will have been in effect for slightly less than two years. Moreover, Deputy Postmaster General Nolan noted projections that the Postal Service could file for new rates in 2003, 2005, and 2007.[25] A two-year rate cycle can allow for a smaller contingency provision.

[25] *PostCom Bulletin*, May 5, 2000, p. 2, and Alliance for Nonprofit Mailers, *Alliance Report*, May 10, 2000, p. 2.

The cost and time involved in requesting and implementing new postal rates (or restocking inventories) must be considered. It would not be wise to attempt to revise them too often, but if the Postal Service initiates regular and more frequent reviews it could provide benefits to certain mailers by providing smaller, more predictable changes in their postage costs, and the overall level of rates could be lower due to a smaller contingency provision. At the same time, as discussed by OCA witness Callow, there are techniques available that could permit the Postal Service to increase convenience to household users of the mail by changing single-piece rates every two rate cases.

In addition, more frequent reviews could allow rates to match costs more accurately over time. Moving to a somewhat shorter rate cycle would have the effect of smoothing the path of postal rates and lowering their average level by reducing the relative size of the contingency provision. Although there are costs associated with a shorter rate cycle, they are likely to be small compared to the cost savings that would flow to customers as a result of a smaller contingency provision.

C. The Contingency Provision Should Not Be Used to Restore The Equity Account

Compare what happens if the contingency provision turns out to be too small versus too large. If the contingency provision turns out to be insufficient, the Postal Service can take actions to increase revenue and/or cut costs, and it can file for another rate increase. Admittedly, rate cases take time to file and for new rates to become effective. However, even if it prefers not to do so, the Postal Service has the ability to borrow from the Federal Financing Bank. Such borrowing is generally on advantageous terms, since no private borrower can borrow on terms equivalent to the

U.S. Treasury's cost of money plus 1/8 percent. At September 30, 1999, the Postal Service had received direct loans from the FFB of $6.279 billion.[26] It is currently limited to an annual increase in debt of $1.0 billion for operating purposes and $2.0 billion for capital investments, with an overall debt ceiling of $15 billion.[27] At the end of FY 1999, the Postal Service had a debt level of $6.9 billion.[28]

Suppose, however, that the Postal Service's revenue and expense projections turn out to be on target and that the 2.5 percent contingency provision is approved. If that happens, the funds flowing from the recovery of prior years' losses ($268.257 million)[29] and the contingency provision ($1.680 billion)[30] will flow to net income and be credited to the equity account. The total amount of $1.948 billion would then be credited to equity, leaving nearly $1.568 billion in equity.[31] Although this would restore the equity account nearly to its original level, this is not the intended method of doing so.

Indeed, with a contingency provision of one percent of estimated costs, if the Postal Service's estimates are on target, $940.163 million will flow into the equity

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26 *Federal Financing Bank: Financial Statements As of September 30, 1999 and 1998 Together With Auditors' Report* (Arthur Anderson, LLP, January 4, 2000), p. 8. Acrobat PDF file downloaded from http://www.treas.gov/ffb/financials/1999_statements/1999_statements.html May 3, 2000.

27 39 U.S.C. § 2005 and Tr. 2/112, 173.

28 Tr. 2/177.

29 USPS-T-9, Table 53, p. 48.

30 2.5 percent of the Total Cost figure shown in USPS Exhibit 9J.

31 Adding the $1.948 billion net income to FY 2000 net equity of ($380.389 million) from USPS-T-9, Table 59, p. 53.

account, which will show a positive balance of approximately $560 million, which will be the first positive balance since 1987.[32]

This could happen. Indeed, the recent success achieved by the Postal Service in meeting or exceeding its breakeven goal has taken some pressure off rates and fees, because the annual charge for recovery of prior years' losses has decreased. However, just as the recovery of prior years' loss allowance should not be seen as a substitute for an adequate contingency provision, the contingency provision should not be used as a substitute mechanism for recovery of prior years' losses. It would not be proper to use the contingency provision, even implicitly, as a mechanism of equity restoration. If the Postal Service wants to accelerate its rate of equity recovery, it can request a shorter amortization period for recovery of prior years' losses rather than using a back-door approach.

D. Increasing the Contingency Provision May Be Counterproductive

In addition, it may be counterproductive for the Postal Service to increase its rates by an additional $1 billion to fund a larger contingency provision, given the "increasingly competitive environment in which the Postal Service operates."[33] The increase in rates necessary to support the enlarged contingency provision cannot help the competitive position of the Postal Service relative to its existing and emerging competitors. If competition is, indeed, increasing, the Postal Service could exacerbate

[32] One percent of Total Costs from USPS Exhibit 9J plus allowance for recovery of prior years' losses.

[33] USPS-T-9, p. 44.

the problem by raising rates by more than is absolutely necessary. It is possible to envision a "vicious cycle" in which rising postal rates create more headroom for competitors, which would result in lower revenues and a call for further rate increases, further encouraging competitors.

VIII. CONCLUSION

The Postal Service has several layers that protect its viability, the contingency provision being one. First, the Postal Service uses *pro forma* estimates of revenues and expenses, so that anything that can be forecasted can be adjusted for. Second, the contingency provision provides some protection against unforeseen, unexpected, and uncontrollable factors that adversely affect revenues and/or expenses. Third, Postal Service management can take actions to increase revenues and/or reduce costs. Fourth, the Postal Service can borrow for operations if it becomes necessary to do so. Fifth, the Postal Service can recover prior years' losses from future rates. Finally, the Postal Service can file for new rates as necessary. Each of these tools is important and has a part to play in maintaining the health of the Postal Service. Given the historical experience of the Postal Service and the relative stability of current economic conditions the Postal Service can continue to meet its objectives and continue the presently allowed contingency provision of one percent of total estimated costs. The increase in the contingency provision from one percent to 2.5 percent of total estimated costs is not necessary at this time.